In The

Supreme Court Of The United States

OCTOBER TERM, 1978

No. 78-78

MARVIN E. SINGLETON, JR. AND
GERTRUDE R. SINGLETON,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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July 1978

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Marvin E. and Gertrude R. Singleton, the Petitioners herein, petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit which reversed the judgment of the United States Tax Court.

OPINIONS BELOW

This case originally involved several issues with regard to only one of which Petitioner seeks review. The opinions of the courts below are printed in an Appendix. The full decision of the Fifth Circuit is reported at 569 F. 2d 863 (1978). It is reprinted in the Appendix (App. pp. A-1 to A-14). The full opinion of the United States Tax Court is reported at 64 T.C. 320 (1975), and is

reprinted in the Appendix (App. pp. A-15 to A-26). Notice of the Order of the Fifth Circuit denying Petitioner's petition for rehearing is set forth in Appendix (App. p. A-27).

JURISDICTION

The decision of the Fifth Circuit was entered on March 16, 1978. A Petition for Rehearing was timely filed by Petitioners, which Petition was denied on April 17, 1978.

The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

It is well-settled authority that in the field of taxation, administrators of the law, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding with regard to the tax implications of commercial transactions. The question here presented is whether the foregoing argument may be asserted by a taxpayer as well as the Commissioner of Internal Revenue in a situation where a taxpayer intentionally utilizes a particular form for substantial non-tax reasons but where the operative facts clearly demonstrate the true substance of the transaction in question.

STATUTES AND TREASURY REGULATION INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.) Section 301(a):

> (a) IN GENERAL. — Except as otherwise provided in this chapter, a distribution of property (as defined in Section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

Internal Revenue Code of 1954 (26 U.S.C.) Section 301(c)(1):

> (c) AMOUNT TAXABLE. — In the case of a distribution to which subsection (a) applies —
>
> (1) AMOUNT CONSTITUTING DIVIDEND. — That portion of the distribution which is a dividend (as defined in Section 316) shall be included in gross income.

Internal Revenue Code of 1954 (26 U.S.C.) Section 316 (a):

> (a) GENERAL RULE. — For the purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders —
>
> (1) Out of earnings and profits accumulated after February 28, 1913, or
>
> (2) Out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distribution made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution is made.
>
> Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which Subsection 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

Treasury Regulations on Income Tax (1954 Code) (26 C. F. R.: Section 1.301 - 1(c)):

> (c) APPLICATION OF SECTION TO SHAREHOLDERS. — Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such.

STATEMENT

During the calendar years 1965 and 1966, Petitioner (Singleton) was a stockholder of Capital Southwest Corporation ("CSW"). As of January 1, 1965, Singleton owned approximately 28,000 shares of CSW which was incorporated in April, 1961. During its fiscal years ending March 31, 1965, 1966 and 1967, CSW declared dividends and made distributions to Singleton.

During its fiscal years ending March 31, 1964, 1965, 1966, and 1967, CSW was the parent of an affiliated group of corporations. This affiliated group included Capital Wire and Cable Corporation ("CW") and other subsidiaries. CSW and its subsidiaries filed consolidated Federal income tax returns for the fiscal years ending March 31, 1964, 1965, 1966, and 1967.

On March 4, 1965, CSW sent a letter to CW in which CSW directed CW's attention to the tax benefits it had enjoyed by virtue of the fact that it had joined with CSW in filing a consolidated return during the prior year (1964) and to the additional benefits that would accrue to it under a similar filing for the upcoming year (1965). The tax savings resulted from the fact that CSW had reported substantial losses which could be used to offset CW's income. The March 4, 1965 letter went on to advise CW to compensate CSW for the use of CSW's tax losses with a payment in the *form* of a dividend in the amount of the anticipated tax savings for CW for these years. This letter was signed on behalf of CSW by M. E. Singleton, President.

On the following day, as reflected in the minutes of the monthly meeting of CW'S Board of Directors, the Directors concluded that filing consolidated returns with CSW in the preceding and current years would result in tax savings estimated at $862,800.00. To avoid any complaint from the minority shareholders of CW, legal counsel to CW advised the Board that the tax should be paid out of CW in "dividend form" and not as a direct payment to CSW. Accordingly, a special dividend of $1.95 per share was declared. This special dividend, combined with the regular $.05 per share semiannual dividend, resulted in a total distribution of $1,000,000, of which $803,750 was paid to CSW as the majority shareholder. The special dividend was paid on March 31, 1965. The evidence of the parties' action in March, 1965, indicates a concern over the direct payment of tax savings for CW to CSW due to possible protests from the minority shareholders of CW. Because of this concern, the tax savings were paid out in the form of a dividend. Prior to 1965, however, CW had made a direct tax payment to CSW of the 1964 tax savings in the amount of $192,483.61. The payment, which

occurred in September of 1964, was nullified in March, 1965 when CSW repaid the money to CW so that it could be included in the "special dividend."

On March 31, 1965, pursuant to the agreement as shown by the letter of March 4, 1965, from CSW to CW and the minutes of the meeting of the board of directors of CW of March 5, 1965, CW made a cash distribution of $1,000,000, of which CSW received $803,750. The consolidated returns as originally filed for the consolidated group for their fiscal years ended March 31, 1964 and 1965 showed no consolidated taxable income and no consolidated tax liability. The income tax liability of the consolidated group was finally determined and settled by the parties in *Capital Southwest Corporation*, Tax Court Docket No. 4643-67, on January 5, 1972. As a result of the settlement, taxable income of the consolidated group was increased for the fiscal years ending March 31, 1964, 1965, 1966, and 1967.

Petitioner was advised by CSW that the distributions to him in March, 1965 and May and July, 1966 were nontaxable and, therefore, did not report them on his Federal income tax returns for the calendar years 1965 and 1966. The Commissioner increased taxpayer's income as reported by $15,535.80 and $9,624.48, respectively, with the explanation that these amounts represented the portions of the distributions to him from CSW in 1965 and 1966 taxable to him as dividends which had not been reported on his income tax returns.

To be taxable to a stockholder under Section 301 of the Internal Revenue Code of 1954, as amended (hereinafter "Code"), a dividend must be paid from the payor's earnings and profits. The question raised below concerned the extent to which the March 31, 1965, distribution to CSW from CW should be treated as a Section 301 dividend and thus included in CSW's earnings and profits account. The Commissioner contended that the full amount of the distribution ($803,750.00) which had been received in 1965 by CSW from CW should be included in its earnings and profits account for 1965 since the tax payment was labeled a "dividend."

The Tax Court, in a reviewed opinion, ruled in petitioner's favor and permitted the amount of the distribution received by CSW in 1965 to be reduced by CW's allocable share of the tax liabilities determined to be due and further ruled that to the extent that said payment to CSW exceeded CW's properly allocable portion of the consolidated tax as finally determined, the payment was to be treated as a dividend to CSW for earnings and profits purposes only.

The decision of the Fifth Circuit reversed the Tax Court and held that where a subsidiary declared a formal dividend to all its stockholders, which dividend bore an admitted relation to the separate return tax saving accomplished by filing of a consolidated tax return with its parent corporation, the payment was not an advance of the allocable amount of the subsidiary's tax liability, but was a "dividend," since the payment was intentionally labeled a dividend by the subsidiary. Thus, the Fifth Circuit held that the parties were bound by the form of their transaction, notwithstanding its true substance.

REASONS FOR GRANTING THE WRIT

One of the most fundamental axioms underlying the entire field of tax law is that the "incidence of taxation depends upon the substance of a transaction." *Commissioner v. Court Holding Company*, 324 US 331 (1945). The proposition that the Federal income tax should be designed to mesh with, and interfere the least with, the operation of American enterprise is not, presumably, a matter of disagreement between taxpayers and the Internal Revenue Service. Our tax structure is not a sweeping, across-the-top gross income tax. Rather, its structure spans the entire breadth of our complex economy, classifies by legal type all economic transactions and imposes upon each classified type certain tax incidents and burdens. The Internal Revenue Code, taken as a whole, represents a composite of Congressional policy as to the spreading, impact, and weighing of the total tax burden on the economy. In order for such a system to correctly function with some measure of certitude, the incidence of taxation must be made to depend upon the economic substance of the transaction in question, not on mere labels.

The doctrine of substance over form thus serves a high purpose. It is a search for the essential reality, seeking to uncover the economic substance of commercial transactions in order to allow the tax burden to fall with the exact weight which Congress intended. The Government will doubtless argue that there is no conflict in the decided cases in this area because they all have their own facts, and so any decision may be distinguished on one ground or another. Indeed, there are literally hundreds of decisions dealing with all types of commercial transactions asserting the right of taxpayers to assert the primacy of substance over form, but there is no consistent thread running through these cases (see, e.g., Rosen, *Substance Over Form - A Taxpayer's Weapon*, 22 U.S.C. Law Center Tax Institute, page 689, 1970) and there are many cases which, if carefully analyzed, ignore ruling Supreme Court authority or attempt to place a specious gloss on the "form v. substance" rule such as is true here where the Fifth Circuit has ruled that a taxpayer may argue substance only if the form in question was accidentally or inadvertently utilized.

This Court has a critically important role in providing guidance and clarification to the lower courts and to lawyers and government officials who are engaged in the administration of the tax laws. It is an appropriate function of this Court to provide such guidance on matters of basic principle in areas which are constantly recurring in tax administration and in the courts. This is especially true where the question is one of great importance on which businessmen and lawyers need light in order that they may intelligently plan and carry out transactions on a basis of reasonable assurance without the inevitability of controversy and litigation with respect to each transaction. Any lawyer who has ever been plagued with the necessity of giving advice on or trying a "substance v. form" case with its myriad perplexing refinements and niceties inevitably realizes that the doctrine weaves itself inextricably throughout the entire field of federal taxation. As indicated above, the doctrine has been applied and misapplied in literally hundreds of cases. The Internal Revenue Service, faced with the inconsistencies in the opinions of the various courts (and not unexpectedly) has increased its attacks in this area and is constantly striving to broaden the doctrine where

it is asserted by the Government and to limit or destroy the doctrine where it is asserted by the taxpayer.

We now live in a time when popular demands for equity and simplicity in our taxing structure are becoming increasingly strident as witnessed by the recent referendum in California and the ongoing battle currently before Congress regarding "reforming" the Federal income tax. If strong, decisive steps are not taken by all those who must work with the tax system, including the courts, our labyrinth tax system is in danger of collapsing of its own weight and our vaunted "voluntary self-assessment" system of collecting taxes could be seriously weakened.

The fundamental importance of the foregoing in a case in which the Government was arguing for an analysis of substance has most recently been recognized by this Court in the case of *Frank Lyon Company v. United States*, 98 S. Ct. 1291 (1978) wherein the following quote appeared at 98 S. Ct. 1298:

> "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding. *Helvering v. Lazarus & Co.*, 308 US 252, 255, (1939). See also *Commissioner v. P.G. Lake, Inc.*, 356 US 260, 266-267 (1958); *Commissioner v. Court Holding Company*, 324 US 331, 334 (1945)."

The holding of this Court in *Helvering v. Lazarus, supra*, is of particular importance, because in that case the Court was faced with a situation where the taxpayer, rather than the Government, was asserting that form should be disregarded in favor of substance. The question in *Lazarus* was whether the taxpayer could show for tax purposes that what was in form an outright deed of real property was in reality an assignment as security for indebtedness. Relying in part upon equitable doctrines, this Court held that the taxpayer could go behind the written document, stating that the taxpayer as well as the Government was entitled to the benefit of the rule that "in the field of taxation, administrators of the laws and the courts are concerned with substance and reality, and formal written documents are not rigidly binding." Thus, this Court many years ago accepted the basic proposition that the taxpayer may use a substance argument in tax litigation to defend against a tax based on the form utilized by him.

Of particular interest is the fact that this Court, in its *Lyon* decision at 98 S. Ct. 1291, stated:

> "The Government places great reliance on *Helvering v. Lazarus & Co., supra*, and claims it to be precedent that controls this case."

Thus, in its briefing before the Supreme Court in *Lyon*, the Government apparently was of the opinion that *Lazarus* is still a viable decision even though it urged the Fifth Circuit in *Singleton* to ignore the basic principle of tax law laid down by *Lazarus*.

Petitioners would urge the Court that it should grant this Writ because the opinion of the Fifth Circuit is in direct conflict with the *Lazarus* opinion of the Supreme Court and, further, is in direct conflict with the opinions of a number of Circuit Courts of Appeal. Petitioners would respectfully urge that the Supreme Court must give favorable consideration to this Writ to complete development of this most critical aspect of tax law that was not directly faced by the Court in *Lyon*, i.e., that the taxpayer continues to enjoy the right to assert substance over form even where the form in question was intentionally utilized by the taxpayer and did not result from taxpayer's inadvertence.

Ten judges of the United States Tax Court described the facts in the instant cause as follows (64 TC 320, 329) (App. A-24):

> "*. . . However, with the substance of the transaction as clear as it is in this case, we would be ignoring substance for form* were we to hold as respondent contends we should that the amount paid by Capital Wire to Capital Southwest was not its 'constructive tax' and therefore a dividend to Capital Southwest only to the extent it exceeded the portion of the consolidated tax properly allocable to Capital Wire.

Cases too numerous to require citation hold that the substance rather than the form of a transaction is controlling for the purposes of applying the Federal tax laws. Here the facts clearly show that the substance of the distributions by Capital Wire to Capital Southwest in the fiscal year ended March 31, 1965, was a 'constructive tax' payment. (Emphasis supplied) [1]

The importance of the characterization of the payment from CW to CSW as a "dividend" or as a "tax allocation payment" is simply that if the payment is a dividend, it increases CSW's earnings and profits; if it is in whole or in part a "tax allocation payment," the payment does not, to that extent, increase CSW's earnings and profits. In turn, the size of CSW's earnings and profits account determines the taxability of the distributions to Petitioner. The primary concepts involved in a determination of whether a given payment by a corporation to its shareholders (or a subsidiary corporation to its parent shareholder) is to be taxed under the rules of Section 301 of the Code are succinctly stated by Bittker and Eustice, supra ftn. 1, at pp. 7-23 and 7-24, as follows:

"The rules of Section 301(c) (under which corporate distributions are to be treated as dividends or returns of capital, depending on the amount of the corporation's current and post-1913 earnings and profits) come into play only if a corporation makes distribution to a shareholder

[1] The decision of the Tax Court was annotated without further comment by the leading authority in the field of corporate income taxation as follows:

". . .See also *Marvin E. Singleton, Jr.*, 64 T.C. 320 (1975) (subsidiary's distribution to parent not a dividend where facts showed payment made to compensate parent for subsidiary's tax savings attributable to being included in consolidated return)" — Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, (3d ed.); 1978 Cumulative Supplement No. 1, pp. S15-16.

'with respect to its stock.' According to Regs. Sec.1.301-1(c), Sec. 301 'is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such.' Thus, if a corporation transfers property to a shareholder who is also a creditor of the corporation in satisfaction of his claim, the transaction is not governed by Section 301. Other examples would include payments to a shareholder-employee as compensation for services, to a shareholder-vendor as payment for property, and to a shareholder-lessor as rent for the use of property. Even if such transfers are regarded as 'distributions,' they are not made to a shareholder 'with respect to (his) stock,' as required by Section 301(a), and hence their tax consequences are governed by other sections of the Internal Revenue Code."

Thus, a distribution from a subsidiary corporation to its parent corporation shareholder is not ipso facto a "dividend" — the substance of the transfer must be ascertained.

In its *Singleton* decision, the Fifth Circuit engaged in sophistic reasoning in its careful sidestepping of a direct repudiation of the taxpayer's right to argue substance over form by its injecting the novel consideration of whether or not the form in question was intended by the taxpayer or whether it was the result of an accident. The gist of the Fifth Circuit's decision was thus stated as follows, at 569 F. 2d 866 (App. A-7):

"The primary difficulty with the Tax Court's application of the 'form vs. substance' principle is that the considerations that may result in a holding contrary to the form of the transaction are totally lacking here. This is not a case in which the transaction came out in the form of a dividend whereas it should have come out as a voluntary payment by the subsidiary to its parent as an 'allocable' amount of its ultimate tax liability. The documents before the Court, together with the parties' stipulation, which formed the sole basis for any evidentiary finding, demonstrate beyond a doubt that CW intended to, and did, declare a dividend to its shareholders. Indeed, CW had to declare a dividend to

its shareholders to get the desired funds in the hands of its parent corporation. The fact that a different tax incidence would have resulted if the subsidiary had been able to make a voluntary contribution to its parent, an 80% stockholder, and ignore the minority stockholders does not justify a judicial reconstruction of the transaction simply to permit the corporation to accomplish the desired result."

It is clear from the foregoing quote that the Fifth Circuit has made a determination that the form in which a transaction is cast is controlling as to its tax consequences even if, as is true in the instant case, the parties to the transaction demonstrate a nontax motivation for the form utilized. The Fifth Circuit has thus held that the "form vs. substance" rule can only be invoked by a taxpayer where the form of the transaction in question is accidentally or inadvertently utilized and cannot be invoked where the form is utilized deliberately for a reason unrelated to taxes (*e.g.*, a concern regarding minority shareholder litigation).

The Fifth Circuit made this determination even though in its opinion, at 569 F. 2d 867 (App. A-9), the Court recognized why the payment in question was cast in the form of a "dividend":

"The letter from CSW and the action of the CW board of directors seem to confirm the idea that CW was willing to transfer to its parent the entire amount that the parties considered had been saved by the use of consolidated returns. If this had been done by CW in the same manner as it was done in *Beneficial* and in *Dynamics*, it would be an act by the directors of CW which would permit the parent to reap all the benefits from filing the consolidated returns. Since CSW owned only 80.375% of CW, it would obviously be contrary to the financial interests of the minority stockholders of CW to allow a direct subsidy payment to CSW of all such benefits. See *Western Pacific R. R. Corp. et v. Western Pacific R. Co.*, 197 F. 2d 994 (9th Cir. 1952) (discussion of such payments by subsidiaries to their parent). See also *Alliegro v. Pan American Bank of Miami*, 136 So. 2d 656 (Fla. App. 1962) (establishing the rights of minority stockholders of a subsidiary in such a situation)."

It would seem clear that the Fifth Circuit recognized the state corporate law considerations which dictated the necessity for the payment of the tax allocation amount in the *form* of a "dividend." Thus, the Fifth Circuit ascribes to CSW contradictory intents: on the one hand it says that the intent of CSW was to have CW pay over the tax savings generated by filing a consolidated return; and on the other hand it says that CSW had an intent to cause CW to pay it a dividend.

Again, the Fifth Circuit, at 569 F. 2d 868 (App. A-12), states:

". . . The intent of CSW was to have CW pay it an amount equal to the entire savings that were contemplated for the several consolidated taxpayers as a result of filing consolidated returns. CSW used its position as 80% stockholder to have this accomplished by a declaration of dividends . . ."

That statement would seem to emphasize the fact that the Fifth Circuit recognized the true nature of the payment in question and the intent of CW in making it, notwithstanding the fact the payment was labeled a dividend.

The operative paragraph of the letter agreement between CSW and CW dealing with the payment (569 F. 2d 865) (App. A-3) reads as follows:

"While it is not in any way anticipated that such shall be the case, should the Internal Revenue Service determine, and be upheld by the courts, that for some reason the consolidation was not proper, or for any reason assert and successfully sustain deficiencies in income tax against Capital Wire & Cable Corporation for either of the stated periods attributable to the foregoing circumstances, then Capital Southwest Corporation herewith agrees to reimburse Capital Wire & Cable Corporation for any deficiencies in Federal income tax it is required to pay for either of these periods; *however, such reimbursement shall be limited to the total amount of the dividend to be paid.*" (Emphasis supplied)

Petitioners submit that the foregoing paragraph is about as clear an indication as would be possible as to the true nature of the payment from CW to CSW.

With regard to the dividend *form* of the payment here in question, it should be noted that there have been a number of Circuit Court and Court of Claims decisions in which taxpayers have sought to show that payments received from corporations pursuant to formal dividend declarations have been in substance something other than, and inconsistent with, true dividends. In each of these cases, the Government has asserted that the payment was taxable as a dividend, or the corporation was not entitled to a deduction for the distribution, because the substance of the transaction was the same as the form and/or because the taxpayer was bound by the form irrespective of the substance. In these cases, however, the courts have held consistently that despite the fact that the corporation had declared a formal dividend and had sufficient earnings and profits to require all or a portion of the dividend to be taxed as ordinary income, the distribution would not be treated as a dividend for tax purposes because the taxpayer had shown that, in reality, the payment was other than a true dividend. See *e.g., Curran v. Commissioner,* 49 F. 2d 129 (8th Cir. 1931) (formally declared dividend held to be in substance payment for real property transferred to the corporation); *Steel Improvement & Forge Co.,* 314 F. 2d 96 (6th Cir. 1963) (taxpayer sold subsidiary to third party and subsidiary declared and paid a formal dividend to the taxpayer as required by the purchaser — court held that the formal dividend was in substance as opposed to form a part of the purchase price.); *Arthur R. Jones Syndicate v. Commissioner,* 23F. 2d 833 (7th Cir. 1927) (corporation which had issued preferred stock providing for annual 14% dividends as expedient to circumvent state usury laws allowed to argue that preferred stock was in substance a borrowing and the dividends declared on it should be deductible as interest.); *Jackson v. Commissioner,* 51 F. 2d 650 (3d Cir. 1931) (corporation declared and paid a formal dividend to stockholders who, pursuant to prior agreement, endorsed the dividend checks back to the corporation as purchase price of additional stock in the corporation - Court sustained the taxpayer's position that in substance as opposed to form, the

cash dividend was in fact a nontaxable stock dividend); *Irving v. United States,* 44 F. 2d 246 (Ct. Cl. 1930) (facts similar to those of *Jackson*); and *Frelbro Corporation v. Commissioner,* 315 F. 2d 784 (2d Cir. 1963) (subsidiary paid certain sums to its parent, including formal cash dividends. Parent had previously agreed to contribute back to the subsidiary a portion of the funds received. In deciding that the parent was not a personal holding company, Court held that the dividend payment and simultaneous recontribution constituted a "wash" under the rule that substance governs over form, agreeing with the parent that only the excess over the amount contributed to the subsidiary constituted a taxable dividend, thus holding that the taxpayer could repudiate the formal dividend declaration.)

Petitioners would thus urge this Court that a Writ of Certiorari should be granted where the decision of the Fifth Circuit below is in direct conflict with one of the most basic and important principles of tax law as enunciated by at least three decisions of this Court, is in conflict generally with hundreds of decisions of various lower courts which have dealt with the question of whether a taxpayer may argue substance over form and, finally, is in direct conflict with decisions of the Eighth Circuit, Sixth Circuit, Seventh Circuit, Third Circuit, Second Circuit and the Court of Claims dealing with substantially identical facts, ie., the characterization of formally declared dividends as being in substance, as opposed to form, other than dividends taxable under Section 301 of the Code where the proposition is urged by the taxpayer, not the Internal Revenue Service.

CONCLUSION

For the reasons stated hereinabove, the Petition for a Writ of Certiorari should be granted.

RESPECTFULLY SUBMITTED,

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Marvin E. SINGLETON, Jr. and Gertrude R. Singleton, Petitioners-Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant.

No. 75-4190.

United States Court of Appeals, Fifth Circuit.

March 16, 1978.

Scott P. Crampton, Asst. Atty. Gen., Michael L. Paup, Arthur L. Bailey, Attys., Gilbert E. Andrews, Act. Chief, Appellate Sect., Tax Div., Dept. of Justice, Meade Whitaker, Chief Counsel, Internal Revenue Service, Washington, D. C., for respondent-appellant.

Anderson Wallace, Jr., Dallas, Tex., for petitioners-appellees.

Appeal from the Decision of the Tax Court of the United States.

Before TUTTLE, COLEMAN and RONEY, Circuit Judges.

TUTTLE, Circuit Judge:

This income tax dispute involves dividends paid to Singleton and his wife (hereinafter "taxpayer") by Capital Southwest Corporation (CSW). The taxability of these payments is in turn dependent upon the character of payments made to CSW by a subsidiary, Capital Wire and Cable Corporation (CW). The Commissioner contends that a distribution of $803,750 by the subsidiary to its parent in 1965 was CSW's part of a duly declared dividend of $1,000,000,

distributed to stockholders of the subsidiary, including CSW and that since it was paid out of earnings and profits, it therefore was a true dividend. The taxpayer, on the other hand, contends, and the Tax Court held, that the payment amounted to an advance of the "allocable" amount of the subsidiary's tax liability, which the Commissioner found to be due seven years later.

The facts are outlined in the Tax Court opinion as follows. During its fiscal years ending March 31, 1964 and 1965, CSW was the parent corporation of an affiliated group of subsidiaries, including CW. CSW and its subsidiaries filed consolidated federal income tax returns for those fiscal years. On March 4, 1965, CSW sent a letter to CW which stated as follows:

> The consolidated Federal income tax return of Capital Southwest Corporation and subsidiaries for the year ended March 31, 1964, included the taxable income of Capital Wire & Cable Corporation for the period from June 1, 1963, to March 31, 1964. It is intended that for the year ended March 31, 1965, a consolidated Federal income tax return also will be filed which will include the taxable income of Capital Wire & Cable Corporation for the year. Capital Wire & Cable Corporation had income in each of the stated periods which would have been subject to Federal income taxes if separate returns were filed; however, such income is off-set by losses, principally those of Capital Southwest Corporation, in the consolidated returns.
>
> Because of the minority interest stock ownership in your corporation, it is deemed advisable for you to pay out as a dividend by March 31, 1965, an amount approximately equivalent to the Federal income tax that would be paid by you for both periods on a separate return basis, rather than paying the full amount of the tax savings up to Capital Southwest Corporation to compensate for the use of its losses in the consolidated return.
>
> While it is not in any way anticipated that such shall be the case, should the Internal Revenue Service determine, and be upheld by the Courts, that for some reason the consolidation was not proper, or for any reason assert and successfully sustain deficiencies in income tax against Capital Wire & Cable Corporation for either of the stated periods attributable to the foregoing circumstances, then Capital Southwest Corporation herewith agrees to reimburse Capital Wire & Cable Corporation for any deficiencies in Federal income tax it is required to pay for either of these periods; however, such reimbursement shall be limited to the total amount of the dividend to be paid.

The minutes of the monthly meeting of the board of directors of CW, held on March 5, 1965, state in part as follows:

There was then a discussion of the tax consequences of the filing of a consolidated Federal Income Tax return with the company's parent, Capital Southwest Corporation. It was pointed out that the consolidation of Capital Wire's tax return with that of Capital Southwest Corporation would completely shield Capital Wire's income from taxes during the fiscal year ending March 31, 1965, and that a similar consolidation in the preceding fiscal year had also eliminated any tax liability on the part of Capital Wire & Cable Corporation. The tax saving effected in this manner amounted to $237,800 in the preceding year and an estimated $625,000 in the current fiscal year—a total of $862,800. Mr. Rains then advised the Directors of the company that although Capital Southwest Corporation was responsible for this elimination of Capital Wire's tax liability, it was his opinion that any distribution of the amount of the tax saving should not be paid directly to Capital Southwest Corporation, but should be paid to all shareholders in dividend form and in such amount as the Board of Directors might establish.

There followed a discussion of the amount of the dividend which the company should declare and it was generally agreed that this amount should bear some relation to the $862,800 tax saving accomplished by the filing of a consolidated

return, with some additional amount in recognition of the company's record earnings during the current year. It was pointed out that a special dividend of $1.95 per share would amount to a total of $975,000, which, combined with the previously declared semi-annual dividend of $0.05 per share, would total $1,000,000. Upon motion duly made, seconded, and unanimously carried, it was:

> RESOLVED that there is declared from the earned surplus of the corporation a special dividend of $1.95 per share on the common stock of the corporation, payable on the 25th day of March, 1965, to holders of such stock at the close of business on the 19th day of March, 1965, and the treasurer is directed and authorized to pay same on the date specified.

On March 31, 1965, pursuant to the agreement evidenced by the March 4, 1965 letter and the March 5, 1965 minutes, CW made a cash distribution of $1 million, of which CSW received $803,750.[1] In its fiscal year ending March 31, 1965, CSW received payments, characterized at the time in its original consolidated income tax return as

1. Although the record is silent as to the percentage of ownership by CSW in CW, the statute, 26 U.S.C. § 1504(a), required at least 80%, and this payment demonstrates ownership of 80.375%.

"dividends from subsidiaries," totaling \$863,843.75. The precise amounts were:

Subsidiary	Amount
Capital Wire & Cable Corp.	\$803,750.00
Southwest Leasing Corp.	40,000.00
Other Subsidiaries	20,093.75
	\$863,843.75 [2]

The consolidated returns as originally filed for the consolidated group for their fiscal years ending March 31, 1964 and 1965 showed no consolidated tax liability.

As a result of a subsequent examination by the Internal Revenue Service, deficiencies for the two years were asserted. They were finally settled by a compromise between the parties in *Capital Southwest Corp.*, Docket No. 4643–67, on January 5, 1972. Substantial taxes were determined to be owed by CSW and CW, amounting to less than the \$803,750 paid by CW to CSW in 1965.[3] The taxpayer contends that only

2. The payments made by subsidiaries other than CW were also in form of dividends. It is noted that when added to the \$803,750 these payments equal enough to "reimburse" CSW for the entire saving of \$862,800. Although taxpayer also claimed the \$40,000 from Southwest Leasing Co. was not a dividend, the Tax Court decided this issue against the taxpayer. The dividends from the other subsidiaries are not now in issue.

3. The parties dispute the amount correctly attributable to CW, but we need not resolve this dispute in view of our disposition of the case.

the amount by which the 1965 payment exceeded the tax liability as finally allocated to CW by the 1972 settlement is to be considered a dividend to CSW in 1965. The Tax Court, six judges dissenting, accepted this view, basing its decision on the rubric that in taxation the court looks to substance rather than form and on what it considered to be relevant court decisions to the effect that the payment by a subsidiary to its parent of the "allocable amount" of the total tax liability for the group is not a dividend but a "constructive" payment of the subsidiary's part of any ultimate tax liability.

The primary difficulty with the Tax Court's application of the "form vs. substance" principle is that the considerations that may result in a holding contrary to the form of the transaction are totally lacking here. This is not a case in which the transaction came out in the form of a dividend whereas it should have come out as a voluntary payment by the subsidiary to its parent as an "allocable" amount of its ultimate tax liability. The documents before the court, together with the parties' stipulation, which form the sole basis for any evidentiary finding, demonstrate beyond a doubt that CW intended to, and did, declare a dividend to its stockholders. Indeed, CW *had to* declare a dividend to get the desired funds in the hands of its parent corporation. The fact that a different tax incidence would have resulted if the subsidiary had

been able to make a voluntary contribution to its parent, an 80 percent stockholder, and ignore the minority stockholders does not justify a judicial reconstruction of the transaction simply to permit the corporation to accomplish the desired result.

Further analysis in this regard underscores this conclusion. CW would have paid $862,800 in taxes for 1964 and 1965 but for the filing of consolidated tax returns by its parent, CSW. Because of large losses suffered by the parent corporation, the large taxable income of CW was thought to have been offset for purposes of the consolidated tax returns for the two years. No taxes were reported or paid for either corporation. If the parent's losses had been insufficient to offset all of CW's taxable income, CSW would have reported and paid taxes on the excess income. This amount would then have been "allocable" to CW as a member of the group which contributed to the tax liability. If the board of directors of CW had voted during the tax year to pay CSW this "allocable" portion of the tax then currently reported and paid by the parent, the case would be similar to *Beneficial Corp. v. Commissioner of Internal Revenue*, 18 T.C. 396 (1952), *aff'd per curiam*, 202 F.2d 150 (3d Cir. 1953) and *Dynamics Corp. of America v. United States*, 392 F.2d 241, 183 Ct.Cl. 101 (1968). In both of those cases there was a consolidated tax liability for the years in question. The subsidiary

corporations, by resolution of their boards of directors, voted to pay over the allocable amount of the consolidated tax liability to their parent corporations. In fact, they paid the entire amount of the savings from the use of consolidated returns. There was no suggestion that the subsidiary corporations were concerned about the rights of minority stockholders when they determined to "compensate" their parent for its use of its loss position to reduce the amount of taxes payable by the group in their consolidated returns. It is not apparent from the opinion in either case whether the directors of the two subsidiary corporations were willing to ignore the rights of the minority stockholders by devoting a substantial amount of their current earnings to reimburse the parent corporation for the full amount of the savings effected or whether the control of the parent was so pervasive as to make this matter unimportant. The taxpayers contended that the whole amount paid by the subsidiaries to the parent was excluded because it was all designated as "reserves for Federal taxes." Both courts held that the excess of the payments over the correct "allocable part" was a dividend, which is all that the Commissioner contended, and which is not in question here.

The letter from CSW and the action of the CW board of directors seem to confirm the idea that CW was willing to transfer to its parent the entire amount that the parties considered had been saved by the use of

consolidated returns. If this had been done by CW in the same manner as it was done in *Beneficial* and in *Dynamics*, it would be an act by the directors of CW which would permit the parent to reap all of the benefits from filing the consolidated returns. Since CSW owned only 80.375 percent of CW, it would obviously be contrary to the financial interests of the minority stockholders of CW to allow a direct subsidy payment to CSW of all such benefits. *See Western Pacific R. R. Corp., et al. v. Western Pacific R. Co.*, 197 F.2d 994 (9th Cir. 1952) (discussion of such payments by subsidiaries to their parent). *See also Alliegro v. Pan American Bank of Miami*, 136 So.2d 656 (Fla.App.1962) (establishing the rights of minority stockholders of a subsidiary in such a situation).

Of course, since CW had earnings sufficient to justify a dividend large enough to "compensate" its majority shareholder for the whole amount saved by the filing of consolidated returns, the minority shareholders could not be heard to complain. They received their dividends on their shares and had no concern with what CSW did with its $803,375 dividend.[4]

4. The Government calls attention to the fact that the taxpayer here was one of the minority stockholders of CW as well as a stockholder in CSW and that he returned his part of the March 31, 1965 dividend as taxable for that year.

As clearly indicated by the correspondence and the minutes, CW declared a dividend of $1.95 per share in addition to the regular semi-annual dividend of $.05 a share already declared. It was generally agreed that these dividends would

> bear some relation to the $862,800 tax saving accomplished by the filing of a consolidated return, *with some additional amount in recognition of the company's record earnings during the current year.* [Emphasis added.]

The stipulation between the parties states: "On March 31, 1965, pursuant to the agreement evidenced by Exhibits 4(d) and 5(e) [the letter and minutes] CW made a cash distribution of $1,000,000 of which CSW received $803,750." This clearly indicates that CSW's share includes its part of the $1.95 special dividend, which the minutes indicated not only bore some relation to the tax saving but also included "some additional amount in recognition of the company's record earnings during the current year." Also, it included CSW's proportionate part of a regular semi-annual dividend of $.05 per share. The record is silent as to the part of the $1.95 dividend that represented a distribution to the shareholders of part of the "record earnings of the year." It does demonstrate, however, that CSW's part of the $.05 dividend was approximately $20,000.

Taxpayer claims that the entire amount of $803,750 was intended not to be a dividend at all, but an "allocable" part of CW's ultimate tax liability for 1964 and 1965 as finally determined by settlement in 1972. Reference to the documents belies this intent. The intent of CSW was to have CW pay it an amount equal to the entire savings that were contemplated for the several consolidated taxpayers as a result of filing consolidated returns. CSW used its position as 80 percent stockholder to have this accomplished by a declaration of dividends. No one contemplated that any amount was ever to be used to pay any taxes allocable to CW. The March 4 letter suggested a dividend "[t]o compensate [CSW] for the use of its losses in the consolidated return." In even more explicit terms the letter stated: "[I]t is not in any way anticipated that the Internal Revenue Service [would] determine, and be upheld by the Courts, that for some reason the consolidation was not proper" or that the Service would "for any reason assert and successfully sustain deficiencies." If the unexpected happened, however, the letter provided that CSW would reimburse CW for any deficiencies that resulted.

The Tax Court's determination that "the intent of the payment by CW to CSW was a payment of CW's 'constructive tax'" is clearly erroneous. As stated by three dissenting judges, "[e]very indicium of a 'dividend' in the tax sense of the word was present herein." The taxpayer concedes

that the earnings and profits of CW were sufficient to enable that company to declare and pay out as a dividend the $1,000,000 that yielded $803,750 to CSW. The record does not disclose how much more earnings and profits were available for the payment of dividends on March 31, 1965.[5]

In light of the clear intent to pay the $1,000,000 as a dividend, the $803,750 received by CSW must be considered as a dividend unless CW had insufficient earnings and profits to permit it to pay both amounts without impairing capital. Otherwise, the taxpayer would be receiving tax-free as a return of capital what should be taxable as dividends. In such a situation the "substance" of the transaction as determined by the Tax Court would be to permit a payment out of earnings and profits to be received tax-free by the taxpayer on the

5. The record does disclose taxable income for the years 1964 and 1965 of $1,881,254.84, which would, of course, be more than sufficient to pay the allocable amount of CW's tax liability, $755,167.22, and the $1,000,000 dividend without impairing capital. The Government concedes that the taxable income figure is not proof of the status of the earnings and profits account of CW. Such figure, however, demonstrates the great likelihood that there were substantially more funds available than required to pay both the allocable portion of CW's taxes and the $1,000,000 in dividends.

6. The taxpayer in his brief commenced his "Summary of Argument" by saying: "This case concerns primarily the question of whether the distributions taxpayer received from

false assumption that it was a return of capital.[6]

[1, 2] Whether it be based upon the presumption of correctness of the Commissioner's deficiency notice or upon the requirement that taxpayer carry the burden of proof of showing the Commissioner's determination to be incorrect, *see Southwestern Life Insurance Co. v. United States*, 560 F.2d 627 (5 Cir. 1977); *MacGuire v. Commissioner of Internal Revenue*, 450 F.2d 1239 (5th Cir. 1971) and *Hord v. Commissioner of Internal Revenue*, 143 F.2d 73 (6th Cir. 1944), the burden was on the taxpayer to produce evidence on the critical issue of whether the accumulated earnings and profits account of CW on March 31, 1965 was sufficient to permit the payment of the dividend on that date together with the ultimately ascertained tax liability of CW in the 1972 settlement. In the absence of such proof, the Commissioner's determination that CSW's part of the declared dividend was in fact a dividend cannot be set aside. *Southwestern Life Insurance Co. v. United States, supra.*

This disposition of the appeal makes it unnecessary to consider the alternative contentions of the parties.

The judgment is REVERSED.

Capital Southwest during 1965 and 1966 were dividends, taxable as ordinary income, or were non-taxable returns of capital."

MARVIN E. SINGLETON, JR., AND GERTRUDE R. SINGLETON, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 573-73. Filed May 29, 1975.

Held, in determining earnings and profits of a parent corporation a distribution by a subsidiary, designated as a "dividend" to the parent at a time when the consolidated return as filed showed no consolidated tax liability, is a dividend to the parent only to the extent that the payment exceeds the subsidiary's allocable portion of the consolidated tax liability as finally determined where the facts clearly show that the distribution was in fact a payment by the subsidiary to the parent of the amount of Federal income tax the subsidiary would have paid if it had filed a separate return and was intended by the subsidiary as a "constructive tax" payment. *Held, further,* a payment by another subsidiary to the parent corporation designated as a dividend when paid is to be treated in its entirety as a dividend in determining the earnings and profits of the parent where the facts do not show the reason for or basis of the payment, even though under sec. 1552, I.R.C. 1954, part of the consolidated tax liability as finally determined is allocable to the subsidiary paying the "dividend."

Anderson Wallace, Jr., for the petitioners.
D. Derrell Davis, for the respondent.

OPINION

SCOTT, *Judge:* Respondent determined deficiencies in petitioners' Federal income taxes for the calendar years 1965 and 1966 in the amounts of $8,039.70 and $4,767.83, respectively. Some of the issues raised by the pleadings have been disposed of by agreement of the parties, leaving for our decision the following: To what extent were distributions received by petitioners with respect to their stock in Capital Southwest Corp. in 1965 and 1966 from the current and accumulated earnings and profits of that corporation so as to constitute taxable dividends to petitioners.

All of the facts have been stipulated and are found accordingly.

Petitioners husband and wife resided in Waxahachie, Tex., at the time their petition in this case was filed. They filed joint Federal income tax returns for the calendar years 1965 and 1966 with the Internal Revenue Service Southwest Service Center, Austin, Tex.

During the calendar years 1965 and 1966 petitioners were stockholders of Capital Southwest Corp. (Capital Southwest). As of January 1, 1965, Marvin E. Singleton, Jr., owned approximately 28,000 shares of Capital Southwest which was incorporated in April 1961. During its fiscal years ending March 31, 1965, 1966, and 1967, Capital Southwest declared dividends and made distributions to Marvin E. Singleton, Jr., as follows:

Date	*Nature of distribution*	*Received*
3/31/65	1,855 shares, Capital Wire stock at $10.125	$18,781.88
11/1/65	Cash	2,100.00
	Total, 1965	20,881.88
5/2/66	Cash	2,000.00
7/20/66	1,200 shares, DPA, Inc., stock at $9.375	11,250.00
11/1/66	Cash	2,000.00
	Total, 1966	15,250.00

The value of these distributions are as set forth above.

During its fiscal years ending March 31, 1964, 1965, 1966, and 1967, Capital Southwest was the parent corporation of an affiliated group of corporations. This affiliated group included Capital Wire & Cable Corp. (Capital Wire), Southwest Leasing Corp. (Southwest), and other subsidiaries. Capital Southwest and its subsidiaries filed consolidated Federal income tax returns for the fiscal years ending March 31, 1964, 1965, 1966, and 1967. Capital Wire and Southwest were not members of the affiliated group after March 31, 1965.

On March 4, 1965, Capital Southwest sent a letter to Capital Wire, which stated as follows:

The consolidated Federal income tax return of Capital Southwest Corporation and subsidiaries for the year ended March 31, 1964, included the taxable income of Capital Wire & Cable Corporation for the period from June 1, 1963, to March 31, 1964. It is intended that for the year ended March 31, 1965, a consolidated Federal income tax return also will be filed which will include the taxable income of Capital Wire & Cable Corporation for the year. Capital Wire & Cable Corporation had income in each of the stated periods which would have been subject to Federal income taxes if separate returns were filed; however, such income is off-set by losses, principally those of Capital Southwest Corporation, in the consolidated returns.

Because of the minority interest stock ownership in your corporation, it is deemed advisable for you to pay out as a dividend by March 31, 1965, an amount approximately equivalent to the Federal income tax that would be paid by you for both periods on a separate return basis, rather than paying the full

amount of the tax savings up to Capital Southwest Corporation to compensate for the use of its losses in the consolidated return.

While it is not in any way anticipated that such shall be the case, should the Internal Revenue Service determine, and be upheld by the Courts, that for some reason the consolidation was not proper, or for any reason assert and successfully sustain deficiencies in income tax against Capital Wire & Cable Corporation for either of the stated periods attributable to the foregoing circumstances, then Capital Southwest Corporation herewith agrees to reimburse Capital Wire & Cable Corporation for any deficiencies in Federal income tax it is required to pay for either of these periods; however, such reimbursement shall be limited to the total amount of the dividend to be paid.

This letter was signed on behalf of Capital Southwest by M. E. Singleton, president.

The minutes of the monthly meeting of the board of directors of Capital Wire, held on March 5, 1965, state in part as follows:

There was then a discussion of the tax consequences of the filing of a consolidated Federal Income Tax return with the company's parent, Capital Southwest Corporation. It was pointed out that the consolidation of Capital Wire's tax return with that of Capital Southwest Corporation would completely shield Capital Wire's income from taxes during the fiscal year ending March 31, 1965, and that a similar consolidation in the preceding fiscal year had also eliminated any tax liability on the part of Capital Wire & Cable Corporation. The tax saving effected in this manner amounted to $237,800 in the preceding year and an estimated $625,000 in the current fiscal year—a total of $862,800. Mr. Rains then advised the Directors of the company that although Capital Southwest Corporation was responsible for this elimination of Capital Wire's tax liability, it was his opinion that any distribution of the amount of the tax saving should not be paid directly to Capital Southwest Corporation, but should be paid to all shareholders in dividend form and in such amount as the Board of Directors might establish.

There followed a discussion of the amount of the dividend which the company should declare and it was generally agreed that this amount should bear some relation to the $862,800 tax saving accomplished by the filing of a consolidated return, with some additional amount in recognition of the company's record earnings during the current year. It was pointed out that a special dividend of $1.95 per share would amount to a total of $975,000, which, combined with the previously declared semi-annual dividend of $0.05 per share, would total $1,000,000. Upon motion duly made, seconded, and unanimously carried, it was:

RESOLVED that there is declared from the earned surplus of the corporation a special dividend of $1.95 per share on the common stock of the corporation, payable on the 25th day of March, 1965, to holders of such stock at the close of business on the 19th day of March, 1965, and the treasurer is directed and authorized to pay same on the date specified.

On March 31, 1965, pursuant to the agreement as shown by the letter of March 4, 1965, from Capital Southwest to Capital Wire and the minutes of the meeting of the board of directors of Capital Wire of March 5, 1965, Capital Wire made a cash distribution of $1 million, of which Capital Southwest received $803,750. In its fiscal year ending March 31, 1965, Capital Southwest received payments characterized at the time in its consolidated income tax return as originally filed as dividends from subsidiaries in the total amount of $863,843.75, comprised of the following:

Subsidiary	*Amount*
Capital Wire & Cable Corp.	$803,750.00
Southwest Leasing Corp.	40,000.00
Other subsidiaries	20,093.75
	863,843.75

The consolidated returns as originally filed for the consolidated group for their fiscal years ended March 31, 1964 and 1965, showed no consolidated taxable income and no consolidated tax liability. The income tax liability of the consolidated group was finally determined and settled by the parties in Capital Southwest Corp., docket No. 4643-67, on January 5, 1972. As a result of the examination and settlement, taxable income of the consolidated group was increased for the fiscal years ending March 31, 1964, 1965, 1966, and 1967.

The following shows the allocation of consolidated income before net operating loss deduction and consolidated tax liability after investment credit as finally determined by the settlement of January 5, 1972, among the members of the consolidated group for the fiscal years 1964 and 1965:

INCOME OF CORPORATIONS HAVING TAXABLE INCOME

FYE Mar. 31, 1964

Name of corporation	*Taxable income*	
Capital Southwest	$163,290.27	(26.44%)
Capital Wire	427,407.63	(69.21%)
Southwest	26,854.56	(4.55%)

FYE Mar. 31, 1965

Name of corporation	*Taxable income*	
Capital Southwest	$209,712.11	(12.40%)
Capital Wire	1,453,846.21	(85.96%)
Southwest	20,082.02	(1.19%)
Alabama	7,562.77	(.45%)

ALLOCATION OF CONSOLIDATED TAX LIABILITY

FYE Mar. 31, 1964

Name of corporation		
Capital Southwest	75,265.10	(26.44%)
Capital Wire	197,015.80	(69.21%)
Southwest	12,382.88	(4.35%)

FYE Mar. 31, 1965

Name of corporation		
Capital Southwest	80,515.09	(12.40%)
Capital Wire	558,151.42	(85.96%)
Southwest	7,726.85	(1.19%)
Alabama	2,921.92	(.45%)

As of March 31, 1964, Capital Southwest had a deficit balance in accumulated earnings and profits of $133,688.70.

On September 25, 1964, Capital Wire made a payment to Capital Southwest in the amount of $192,483.61. This amount was subsequently repaid to Capital Wire on March 12, 1965. This amount is the amount of income tax Capital Wire computed it would have had to pay if it filed a separate return for the fiscal year ending March 31, 1964, rather than joining in the consolidated return with Capital Southwest.

Petitioners were advised by Capital Southwest that the distributions to them in March 1965 and May and July 1966 were nontaxable and therefore did not report them on their Federal income tax returns for the calendar years 1965 and 1966. Respondent in his notice of deficiency increased petitioners' income as reported by $15,535.80 and $9,624.48, respectively, with the explanation that these amounts represented the portions of the distributions to them from Capital Southwest in 1965 and 1966 taxable to them as dividends which had not been reported on their income tax returns.

Petitioners take the position that they correctly reported the dividend income they received from Capital Southwest in 1965 and 1966 since in their view Capital Southwest had no current or accumulated earnings and profits from which the distributions to them, other than those reported on their return or conceded by them in this case to be taxable, could be paid and therefore these

distributions were not dividends under the definition contained in section 316, I.R.C. 1954.[1] Petitioners recognize that, even though a distribution by one member of an affiliated group filing consolidated returns is not includable in the taxable income of the corporation receiving the distribution in computing the consolidated income, intercompany dividends are part of the earnings and profits of the recipient corporation for the purposes of determining whether a distribution by that corporation to its shareholders is a dividend within the definition of section 316.

Petitioners, however, take the position that the distributions to Capital Southwest in the amount of $803,750 by Capital Wire and in the amount of $40,000 by Southwest in the fiscal year ended March 31, 1965, were in substance as distinguished from form, payments by these subsidiaries to their parent corporation for their allocable portion of the consolidated income tax of the affiliated group for the fiscal years 1964 and 1965. Petitioners contend that for this reason the distributions constituted dividends to Capital Southwest from its subsidiaries only to the extent that the amounts distributed are in excess of the distributing corporation's allocable portion of the consolidated income tax as finally determined on January 5, 1972, relying on *Beneficial Corp.*, 18 T.C. 396 (1952), affd. per curiam 202 F. 2d 150 (3d Cir. 1953); and *Dynamics Corp. of America v. United States*, 392 F. 2d 241 (Ct.Cl. 1968). Each of these cases involved an amount paid by a subsidiary corporation to its parent in the year following the close of a year in which it, as a member of an affiliated group, filed a consolidated return with its parent as its part of the consolidated income tax. We held in the *Beneficial Corp.* case that to the extent the payment exceeded the portion of the consolidated tax liability properly allocable to the income of the subsidiary making the payment included in the consolidated return, the payment constituted a dividend to the parent to the extent of the subsidiary's current or accumulated earnings and profits. The holding of the Court of Claims in the *Dynamics Corp.* case is to the same effect. In the *Beneficial Corp.* case and apparently in the *Dynamics Corp.* case the payment was treated by the parent on its books as being with respect to Federal tax.

[1] All references are to the Internal Revenue Code of 1954 unless otherwise indicated.

Petitioners argue that although the amounts distributed by Capital Wire and Southwest to Capital Southwest were characterized as dividends on the consolidated return as originally filed, the reason for this characterization was that there was no consolidated tax liability as shown on the consolidated tax return as originally filed with the result that there was at the time of the distribution no allocable portion of the consolidated tax for any subsidiary to pay. Petitioners state that since the entire distribution exceeded the amount of each subsidiary's allocable portion of tax as shown on the consolidated return as originally filed, the entire payment was treated as a dividend. Petitioners contend that the substance of the transactions here is that the payments were made by the subsidiaries to the parent to compensate the parent for use of the parent's losses which caused the subsidiaries not to pay tax which they would have paid if they had filed separate returns. Petitioners cite and rely on a number of cases in which it has been held that an amount paid by a subsidiary to a parent designated as a dividend was in substance not a dividend, such as *Steel Improvement & Forge Co. v. Commissioner*, 314 F. 2d 96 (6th Cir. 1963), revg. 36 T.C. 265 (1961), in which a payment designated a dividend was held to be in substance a payment of part of a purchase price of stock, and *Frelbro Corp. v. Commissioner*, 315 F. 2d 784 (2d Cir. 1963), revg. 36 T.C. 864 (1961), in which it was held that a payment designated a dividend was in fact merely a bookkeeping entry of exchanges between two related corporations.

Petitioners point out that the consolidated income tax as finally determined was properly allocated to the various subsidiaries in accordance with the provisions of section 1552(a)(1) and that this proper allocation is stipulated. Petitioners further point out that it has been held that in computing corporate earnings and profits, Federal taxes as finally determined, even though the final determination is made many years subsequent to the year to which the tax is applicable and is contested throughout the intervening years, must be accrued and deducted for the year to which applicable. *Stern Bros. & Co.*, 16 T.C. 295, 323 (1951); *Estate of Esther M. Stein*, 25 T.C. 940, 965 (1956), affd. per curiam 250 F. 2d 798 (2d Cir. 1958); *Robert Deutsch*, 38 T.C. 118, 124 (1962). Petitioners conclude, therefore, that since any income tax determined against Capital Southwest or any of its subsidiaries in 1972 applicable to the fiscal years ended

March 31, 1964 and 1965, would, in computing earnings and profits of the parent and each subsidiary, be accrued as of March 31, 1964, and March 31, 1965, any payments made by the subsidiary to the parent to compensate the parent for the saving in Federal income tax resulting to the subsidiary because of the use of the parent's losses should be considered as a payment by the subsidiary for its allocable portion of the consolidated income tax for the year to which the tax is applicable regardless of when the final settlement of the tax liability occurred.

Respondent does not deny that when a deficiency or overpayment of income tax of an accrual basis corporation is finally determined, the amount is accrued as of the year to which it applies for the purpose of computing earnings and profits. Respondent takes the simple position here that the amounts distributed to Capital Southwest by Capital Wire and by Southwest in the fiscal year ended March 31, 1965, were distributed as dividends since the consolidated income as then reported on the consolidated return showed no tax liability. Furthermore, respondent takes a contrary position to that taken by petitioners with respect to the implication of the agreement between Capital Southwest and Capital Wire. Respondent states that this agreement, although showing that the payment was to "compensate" Capital Southwest "for the purchase and use of its losses," was for the payment of a dividend and that the resolution adopted by Capital Wire was for the payment of a dividend.

In our view respondent's position is too simplistic. When a consolidated return is filed the tax is that of the consolidated group. Section 1552[2] provides that when a consolidated return is filed

[2] SEC. 1552. EARNINGS AND PROFITS.

(a) GENERAL RULE.—Pursuant to regulations prescribed by the Secretary or his delegate the earnings and profits of each member of an affiliated group required to be included in a consolidated return for such group filed for a taxable year beginning after December 31, 1953, and ending after the date of enactment of this title, shall be determined by allocating the tax liability of the group for such year among the members of the group in accord with whichever of the following methods the group shall elect in its first consolidated return filed for such a taxable year:

(1) The tax liability shall be apportioned among the members of the group in accordance with the ratio which that portion of the consolidated taxable income attributable to each member of the group having taxable income bears to the consolidated taxable income.

* * *

(4) The tax liability of the group shall be allocated in accord with any other method selected by the group with the approval of the Secretary or his delegate.

(b) FAILURE TO ELECT.—If no election is made in such first return, the tax liability shall be allocated among the several members of the group pursuant to the method prescribed in subsection (a)(1).

"the earnings and profits of each member of an affiliated group * * * shall be determined by allocating the tax liability of the group for such year among the members of the group" by one of the methods there set forth. Respondent, in recognition of this provision, states that each Capital Wire and Southwest is entitled to accrue at the end of its fiscal years 1964 and 1965 its allocable portion of the consolidated Federal income tax as finally determined on January 5, 1972. Respondent contends, however, that the fact that this tax is accrued for the purpose of computing earnings and profits does not cause amounts initially paid as a "dividend" to compensate for the use by Capital Wire of Capital Southwest's losses with the resultant tax saving to Capital Wire to constitute a "constructive" tax payment by Capital Wire to Capital Southwest to the extent of Capital Wire's accrued taxes.

In the *Dynamics Corp.* case the Court referred to the payments by the subsidiary to the parent as "constructive tax payments." While it is not completely clear from the *Beneficial Corp.* and *Dynamics Corp.* cases, it appears that the reason that the payments in each of these cases by the subsidiary to the parent was in excess of the subsidiary's allocable portion of the tax was that the subsidiary made a payment to the parent on the basis of what its Federal income tax would have been had it filed a separate return rather than of its proper allocable portion of the consolidated tax liability. The facts here show that Capital Wire paid a "dividend" to its stockholders based primarily on what its Federal income tax would have been had it filed a separate return. That the intent of the payment by Capital Wire to Capital Southwest was a payment of Capital Wire's "constructive tax" is further shown by Capital Southwest's agreement to reimburse Capital Wire for any Federal income tax which might subsequently be determined against it. In our view the agreement between Capital Wire and Capital Southwest here is not substantially different from the agreement between the parent and subsidiary in the *Dynamics Corp.* case. In that case some consolidated liability was shown on the return whereas in the instant case none was shown. However, in both cases the payment by the subsidiary to the parent was for the "constructive tax" that the subsidiary would have owed had it filed a separate return. For the many reasons stated in the *Beneficial Corp.* and the *Dynamics Corp.* cases, to the extent that the payment exceeded Capital Wire's properly allocable portion of the consolidated tax as

finally determined, the payment is a dividend to Capital Southwest to the extent of Capital Wire's earnings and profits. However, with the substance of the transaction as clear as it is in this case, we would be ignoring substance for form were we to hold as respondent contends we should that the amount paid by Capital Wire to Capital Southwest was not its "constructive tax" and therefore a dividend to Capital Southwest only to the extent that it exceeded the portion of the consolidated tax properly allocable to Capital Wire.

Cases too numerous to require citation hold that the substance rather than the form of the transaction is controlling for the purposes of applying the Federal tax laws. Here the facts clearly show that the substance of the distributions by Capital Wire to Capital Southwest in the fiscal year ended March 31, 1965, was a "constructive tax" payment. We therefore conclude that this distribution is a dividend to Capital Southwest includable in its earnings and profits for the fiscal year 1965 only to the extent that it exceeded Capital Wire's allocable portion of the consolidated Federal income tax liability as finally determined for the fiscal years 1964 and 1965.

The record is devoid of information as to the facts surrounding Southwest's distribution to Capital Southwest in the fiscal year 1965. There is nothing to show whether the distribution was a routine dividend or had some relation to Southwest's tax savings from the filing of a consolidated return with Capital Southwest. We have no basis in the facts here to show that this distribution was other than a dividend. We therefore hold that the $40,000 distribution by Southwest to Capital Southwest in the fiscal year 1965 was a dividend includable in the earnings and profits of Capital Southwest in that fiscal year.

Reviewed by the Court.

Decision will be entered under Rule 155.

TANNENWALD, *J.*, dissenting: Every indicium of a "dividend," in the tax sense of that word, was present herein. That Capital Southwest undertook an obligation to reimburse Capital Wire for the latter's share of a liability that might later be found to exist would not, in the usual situation, justify an ex post facto offset to the amount of the distribution which should properly be treated

as a dividend. See *United States v. Lesoine*, 203 F.2d 123 (9th Cir. 1953); *Estate of Lloyd E. Crellin*, 17 T.C. 781 (1951), affd. 203 F.2d 812 (9th Cir. 1953). Compare *Likins-Foster Honolulu Corp. v. Commissioner*, 417 F.2d 285, 290-291 (10th Cir. 1969), affg. on this issue T.C. Memo. 1967-207 and T.C. Memo. 1966-273. Compare also sec. 1.301-1(g), Income Tax Regs., with sec. 1.461-1(a)(2), Income Tax Regs., and *F. & D. Rentals, Inc. v. Commissioner*, 365 F.2d 34, 41 (7th Cir. 1966), affg. 44 T.C. 335 (1965); *Columbus & Greenville Railway Co.*, 42 T.C. 834 (1964), affd. per curiam 358 F. 2d 294 (5th Cir. 1966).

But, it is not enough to determine that the distribution from Capital Wire to Capital Southwest was a dividend. The ultimate issue herein is the amount of Capital Southwest's earnings and profits. The resolution of this issue requires us to decide whether the promise of reimbursement by Capital Southwest should be equated with an assumption of direct liability for Capital Wire's share of the tax as finally determined against the consolidated group and, if so, whether the obligation should be considered a tax liability of Capital Southwest so as to fall within the ambit of the cases holding that contested tax liabilities are attributed in the case of an accrual basis taxpayer to the taxable year to which they relate for the purpose of computing earnings and profits. See *Estate of Esther M. Stein*, 25 T.C. 940, 965-966 (1956), affd. per curiam 250 F.2d 798 (2d Cir. 1958); *Stern Bros. & Co.*, 16 T.C. 295 (1951). In such event, there would be a corresponding reduction in earnings and profits having the effect of offsetting the dividend.

For my own part, I would stop short of holding that there was an assumption of liability herein. The letter agreement between Capital Wire and Capital Southwest constituted at most a promise by the latter to reimburse the former for an amount equal to Capital Wire's share of the consolidated tax liability as finally determined. Such a promise does not, in my opinion, constitute an assumption of liability sufficient to support a direct liability by Capital Southwest for the portion of the consolidated tax allocable to Capital Wire, separate and apart from the amount allocated to Capital Southwest by the provisions of the statute and the regulations. Sec. 1552; sec. 1.1552-1(b)(2), Income Tax Regs.

Thus, I would hold that Capital Southwest's obligation to Capital Wire was no different from any other business liability

and, since its amount was not determinable in the taxable year involved, it was not accruable in that year. To make a retroactive adjustment to earnings on the basis of the agreement between Capital Southwest and Capital Wire would be to confuse an obligation which is contingent on a tax liability with one which is a contingent tax liability and greatly extend the principle of *Stein* and *Stern Bros.*[1]

DAWSON and IRWIN, *JJ.*, agree with this dissent.

QUEALY, *J.*, dissenting: The amount in question was declared and paid out of earnings and profits as a dividend of $1.95 per share by the subsidiary to its parent corporation and minority stockholders. The opinion of the Court certainly does not suggest that the $1.95 dividend was anything but a dividend to the extent that it was paid to the minority stockholders. I find nothing in the statute or the respondent's regulations regarding the filing of consolidated returns which would warrant reclassifying the payment of $1.95 to the majority stockholder, after the fact, as anything else but a dividend.

DAWSON, RAUM, IRWIN, and HALL, *JJ.*, agree with this dissent.

[1] That principle has been said to "add to the complexity of this [earnings and profits] area, without making any offsetting contribution to rationality." Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders 7-21 to 7-22 (3d ed. 1971).

United States Court of Appeals

FIFTH CIRCUIT

EDWARD W. WADSWORTH
CLERK

OFFICE OF THE CLERK

TEL 504-589-6514
600 [illegible]
NEW [illegible]

APR 1978
RECEIVED

April 17, 1978

TO ALL PARTIES LISTED BELOW:

NO. 75-4190 - MARVIN E. SINGLETON, JR., ET AL.
COMMISSIONER OF INTERNAL REVENUE

Dear Counsel:

This is to advise that an order has this day been entered denying the petition( ) for rehearing** and no member of the panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 12) the petition( ) for rehearing en banc has also been denied.

See Rule 41, Federal Rules of Appellate Procedure for issuance and stay of the mandate.

Very truly yours,

EDWARD W. WADSWORTH, Clerk

By Brenda M. Hauck
Deputy Clerk

**on behalf of appellees, Marvin E. Singleton, et al.,

bmh

cc: Messrs. Scott P. Crampton
Michael L. Paup
Arthur L. Bailey
Mr. Gilbert Andrews
Mr. Meade Whitaker
Mr. Anderson Wallace, Jr.

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No. 78-78

In the Supreme Court of the United States

OCTOBER TERM, 1978

MARVIN E. SINGLETON, JR. AND
GERTRUDE R. SINGLETON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-78

MARVIN E. SINGLETON, JR. AND
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v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The question presented in this federal income tax case is whether certain cash distributions petitioner Marvin E. Singleton, Jr.[1] received with respect to his stockholding interest in Capital Southwest were taxable to him as dividends, as the decision below held, or whether they were nontaxable returns of capital, as petitioner contends. The resolution of that question turns upon whether Capital Southwest had sufficient earnings and profits during the years in question so that the distributions to petitioner were "out of" its earnings and profits within the meaning of Sections 301(c)(1) and 316(a) of the Internal Revenue Code of 1954 (26 U.S.C.).

[1]References to "petitioner" are to Marvin E. Singleton. Gertrude R. Singleton is a party solely because she filed a joint return with her husband for the years in question.

The pertinent facts are undisputed and may be summarized as follows: Capital Southwest was the parent corporation of a group of affiliated corporations, including Capital Wire, and joined with its affiliates in filing consolidated income tax returns. Prior to the close of its taxable year 1965, Capital Southwest's president stated in a letter to Capital Wire that for taxable years 1964 and 1965, Capital Wire had been able to avoid federal income taxes on its income because that income had been offset on the consolidated return by Capital Southwest's losses. The letter went on to "advise" that Capital Wire—

> pay out as a dividend by March 31, 1965, an amount approximately equivalent to the Federal income tax that would be paid by you for both periods on a separate return basis, rather than paying the full amount of the tax savings up to Capital Southwest Corporation to compensate for the use of its losses in the consolidated return.

In closing, Capital Southwest's president agreed on behalf of his corporation to "reimburse" Capital Wire for any deficiencies in income taxes that might thereafter be determined against Capital Wire and "upheld by the Courts" (Pet. App. A-2 to A-3, A-16 to A-17).

The following day, Capital Wire's board of directors held their monthly meeting. According to the minutes of that meeting, the directors determined that Capital Wire had been able to achieve a "tax saving" of approximately $862,000 through the filing of consolidated returns. The directors were advised, however, that—

> although Capital Southwest Corporation was responsible for this elimination of Capital Wire's tax liability, * * * the amount of the tax saving should not be paid directly to Capital Southwest Corporation, but should be paid to all shareholders in dividend form and in such amount as the Board of Directors might establish.

The board then discussed—

> the amount of the dividend which the company should declare and it was generally agreed that this amount should bear some relation to the $862,800 tax saving accomplished by the filing of a consolidated return, with some additional amount in recognition of the company's record earnings during the current year.

The board thereupon voted to declare a March 25 dividend of $975,000, which increased its total distributions for the year to $1 million. As the principal shareholder of Capital Wire, Capital Southwest received $803,750 of this $1 million (Pet. App. A-3 to A-6, A-17 to A-18).

On audit, the Commissioner of Internal Revenue determined that the consolidated returns Capital Southwest and Capital Wire had filed for their taxable years 1964 and 1965, which had reported no taxable income and no tax liability, did not accurately reflect the earnings of the consolidated group. Although the corporations sought a redetermination of the deficiencies asserted against them in the Tax Court, that suit was settled and the corporation agreed to deficiencies in income taxes of approximately $900,000, of which approximately $755,000 was allocable to Capital Wire. In accordance with its undertaking in the letter of March 4, 1965, Capital Southwest paid all taxes allocable to Capital Wire as determined under the stipulated 1972 Tax Court decision[2] (Pet. App. A-6, A-18 to A-19).

[2]After application of certain operating loss carrybacks, Capital Southwest was able to satisfy the compromise decision by paying

Petitioner took the position that Capital Southwest's 1972 payment retroactively reduced the amount of its earnings and profits for 1965 by $755,000 and retroactively served to transform the distributions Capital Southwest had made to petitioner from dividends to nontaxable returns of capital. The Tax Court, over five dissents, upheld petitioner's contentions (Pet. App. A-15 to A-26). The court of appeals reversed. It ruled that the dividend declared by Capital Wire was a dividend, just as it intended and declared, and thereby includable in Capital Southwest's earnings and profits. It therefore followed that the distributions petitioner received in 1965 and 1966 were taxable to him as dividends out of Capital Southwest's earnings and profits (Pet. App. A-1 to A-14).

The decision below correctly held that Capital Southwest had sufficient earnings and profits so as to render petitioner's distributions taxable dividends for 1965 and 1966. Petitioner's sole contention is that Southwest's 1972 payment for Capital Wire's tax liability served retroactively to transform the dividend it received from Capital Wire in 1965 into a tax allocation payment. But as this Court observed in *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149:

> [W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, *Higgins* v. *Smith*, 308 U.S. 473, 477 (1940); *Old Mission Portland Cement Co.* v. *Helvering*, 293 U.S. 289, 293 (1934); *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935), and may not enjoy the benefit of some other route he might have chosen to follow but did not. "To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty." *Founders General Corp.* v. *Hoey*, 300 U.S. 268, 275 (1937); *Television Industries, Inc.* v. *Commissioner*, 284 F. 2d 322, 325 (CA2 1960); *Interlochen Co.* v. *Commissioner*, 232 F. 2d 873, 877 (CA4 1956). See *Gray* v. *Powell*, 314 U.S. 402, 414 (1941).

$254,565.98, of which $218,824.92 was attributable to Capital Wire's tax liabilities (R. 14) ("R." refers to the record appendix in the court of appeals).

No matter what might have prompted Capital Wire's declaration of a dividend in 1965, it cannot be disputed that it chose to declare such a dividend. It did so in accordance with Capital Southwest's "advice" to it and for substantial business reasons. Under the rationale of *National Alfalfa Dehydrating*, there is no basis for recharacterizing the 1965 dividend as a tax allocation payment. Cf. *Moline Properties* v. *Commissioner*, 319 U.S. 436.

Nor should Capital Southwest's agreement to pay all taxes that might later be determined against Capital Wire for 1964 and 1965 affect that conclusion. Had no liability ever attached to this agreement, the full amount of the 1965 dividend distribution would unquestionably be includable in Capital Southwest's earnings and profits for 1965. The fact that the contingent obligation Capital Southwest assumed in connection with the dividend from Capital Wire ultimately gave rise to liability following the 1972 settlement of the Tax Court case in no way serves to reduce retroactively the amount so includable. Cf. *Estate of Crellin* v. *Commissioner*, 17 T.C. 781. None of the

cases petitioner cites[3] even remotely suggests that a dividend might be retroactively recharacterized by virtue of events that occur only years after the distribution is made. Indeed, such a retroactive recharacterization would undermine the annual accounting concept which is fundamental to our income tax system. See, *e.g.*, *United States* v. *Consolidated Edison Co.*, 366 U.S. 380; *Healy* v. *Commissioner*, 345 U.S. 278.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

WADE H. MCCREE, JR.,
Solicitor General.

AUGUST 1978.

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[3]Most of the cases on which petitioner relies (Pet. 14-15) (*Frelbro Corp.* v. *Commissioner*, 315 F. 2d 784 (C.A. 2); *Steel Improvement and Forge Co.* v. *Commissioner*, 314 F. 2d 96 (C.A. 6); *Jackson* v. *Commissioner*, 51 F. 2d 650 (C.A. 3); *Curran* v. *Commissioner*, 49 F. 2d 129 (C.A. 8); *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833 (C.A. 7)) were decided before *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, *supra*. *Frank Lyon Co.* v. *United States*, No. 76-624, decided April 18, 1978, and *Helvering* v. *Lazarus & Co.*, 308 U.S. 252, upon which petitioner also relies (Pet. 8-9), involved questions concerning the ownership of property for purposes of claiming depreciation deductions. They accordingly have no application to the payment characterization issue here.

In The
Supreme Court of The United States

October Term, 1978

No. 78-78

Marvin E. Singleton, Jr. and
Gertrude R. Singleton,

Petitioners,

vs.

Commissioner of Internal Revenue,

Respondent.

REPLY MEMORANDUM FOR THE PETITIONERS

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September, 1978

In the
Supreme Court of the United States

October Term, 1978

No. 78-78

Marvin E. Singleton, Jr. and
Gertrude R. Singleton,

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vs.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY MEMORANDUM FOR THE PETITIONERS

This reply to the Government's Memorandum In Opposition is filed because the Government has failed to face the important issue of federal income tax administration presented by the decision below. The Government has instead based its argument on its newly-raised assertion that the resolution of the "form vs. substance" issue in this case is controlled by *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

National Alfalfa dealt with a situation where a taxpayer urged the Supreme Court to look to what the taxpayer termed the "economic realities" of the transaction in question. The taxpayer thus asked the Court to speculate on the tax effect of a hypothetical transaction which the taxpayer argued could have been substituted for what actually took place.

Petitioners would urge this Court that the Government's reliance on *National Alfalfa* demonstrates the importance of granting the Writ of Certiorari. Petitioners do not believe that Mr. Justice Blackmun, writing for the Court in *National Alfalfa*, intended to overrule all of the hundreds of cases which have held that a taxpayer as well as the Government may argue the primacy of substance over form without his ever using the terms "form" or "substance" or without making reference to any of the Supreme Court authorities which consider the "form vs. substance" question.[1]

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[1]This apparent Government misunderstanding of the holding in *National Alfalfa* would appear to explain the curious footnote in the Memorandum In Opposition (ftn. 3 at page 6) in which the Government seems to suggest that *National Alfalfa* overruled some, but not all, of the cases which have held that a taxpayer, as well as the Government, may assert the primacy of substance. *Helvering v. Lazarus & Co.*, 308 U.S. 252, clearly stands for the proposition that a taxpayer may assert the primacy of substance over form. This court cited *Helvering v. Lazarus & Co.* in its discussion of "form vs. substance" in *Frank Lyon Company v. United States*, 98 S.Ct. 1291, 1298.

To argue that a particular transaction should be characterized for federal income tax purposes in a particular manner because of its substance, not because of the labels applied, is not to argue (as did the taxpayer in *National Alfalfa*) that a taxpayer may rebut clear substance by asking the court to speculate as to what he might have done differently, i.e., an alleged "economic equivalence" of a different substance which carries a different tax treatment.

In order to provide badly needed clarity in this important area of tax administration, the Court should grant the Writ of Certiorari.

Respectfully submitted,

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September, 1978